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Monthly Investment Report

February 2014

SUMMARY: ***U.S. stocks got off to a weak start in 2014, their weakest since 2009, with January's loss in the market averages their first since last August. U.S. stocks still managed to outperform foreign stocks, particularly emerging markets, where turmoil ensued following a report of contraction in Chinese manufacturing. That sparked a rush into U.S. Treasury securities, which had positive returns in January after losing money last year. The Fed announced its second installment of bond purchase tapering, which may have added to unease in global markets.***

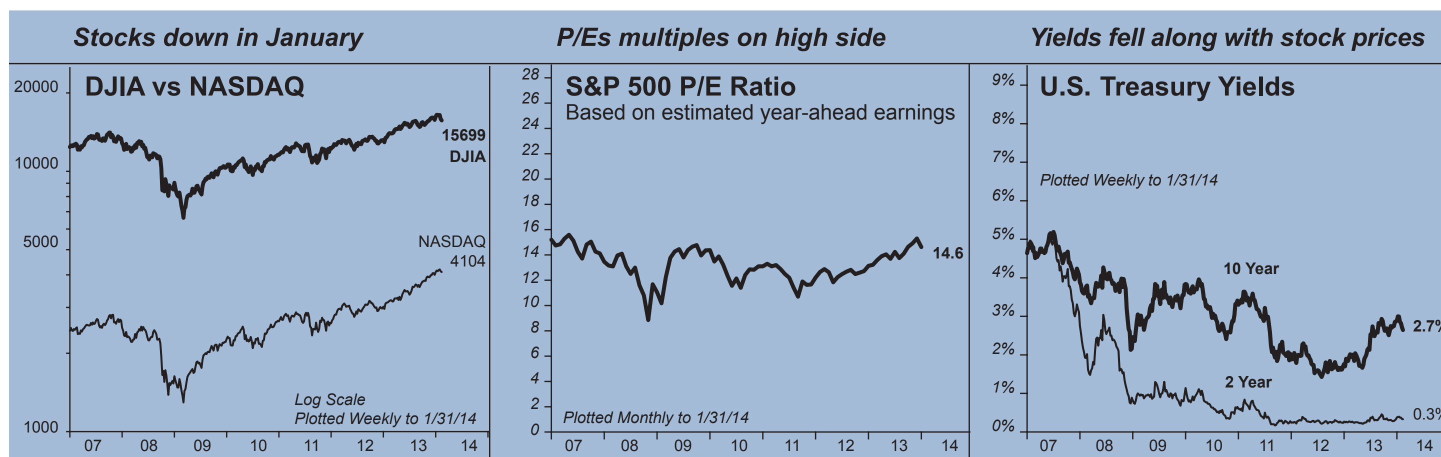
Whether it was profit-taking following the best year for stocks since 1997 or turmoil in emerging markets, U.S. stocks had negative returns in January for the first time in five months. All three major indexes fell, their first monthly losses since August. The Dow was the weakest of the three, losing 5.2%, its worst January since 2009; the S&P 500 fell 3.5%, its worst start to a year since 2010; NASDAQ fell 1.7%. Among the S&P's 10 sectors, defensive, bond-like utilities were the best performers with a 3.0% return last month. At the other extreme, energy stocks (which lost 6.3%) and the two consumer sectors (both down more than 5%) were the S&P 500's weakest sectors.

Foreign stocks performed worse than their U.S. counterparts in January. The MSCI Developed World ex U.S. index lost 4% in U.S. dollars during the month. The MSCI Emerging Markets index lost 6.5%, with the BRICS markets (Brazil, Russia, India, China and South Africa) losing an average of 11%. The downturn in the developing world appeared to be sparked by a contraction in Chinese manufacturing, which raised concerns that it would carry over into smaller countries.

January was a good month for bonds, with the Barclays U.S. Aggregate posting a positive return of 1.5% after losing 2% in 2013. In contrast to last year, long-term U.S. Treasury securities had strong returns during the month as investors sought a safe haven amid the turmoil in emerging markets. After ending 2013 at their highest levels in two years, yields on long-term Treasury bonds fell sharply. The yield on the 10-year T-note fell 36 basis points to 2.67% while the yield on the 30-year bond dropped 34 bps to 3.62%, three-month lows in each case.

Reports from the government and private sector continued to show a strengthening U.S. economy. Fourth-quarter GDP rose at a fairly robust 3.2% annualized pace, better than forecast. For the full year 2013, GDP grew 1.9%, down from 2.8% in 2012, but growth was sharply higher in the second half compared to the first, providing positive momentum as 2014 began. The Federal Reserve's latest Beige Book, covering December and late November, showed the recovery expanding to more regions of the country. "The economic outlook is positive in most districts," the report said. Retail sales rose 0.2% in December but 0.6% excluding autos and gasoline. The Conference Board's consumer confidence index rose more than three points to 80.7 in January, a five-month high, after rising more than five points in December.

Outside the consumer sector, though, indicators were a bit uneven. Durable goods orders fell 4.3%, the biggest decline in five months. On the positive side, industrial production rose 0.3% in December, bringing its Q4 rise to a 6.8% annual rate, the best calendar quarter in 3¼ years. Inflation remains largely



a non-issue, with firms struggling to exert pricing power. Consumer prices rose 0.3% in December but only 1.5% for the full year; core CPI inflation is running at a 1.7% annual rate.

Rising home prices have taken some of the steam out of the housing recovery. The S&P Case-Shiller home price index showed prices rising 13.8% in the year through November. While that's certainly good news for homeowners and sellers, it's starting to hurt sales. Pending home sales dropped nearly 9% in December, the biggest monthly drop since May 2010. The National Association of Realtors blamed some of the drop on "unusually disruptive weather" but added that home prices are rising faster than incomes, which is "giving pause to some potential buyers." New home sales fell 7% to an annual rate of 414,000 in December, while the government's estimate for November was revised sharply lower. For full year 2013, however, new home sales totaled roughly 430,000, up 17% from the prior year.

No economic indicator has been more erratic or frustrating for policy makers and job seekers than job creation. In December the economy added only 74,000 net new jobs, a nearly three-year low. Most of the new jobs were of the lower-paying, service sector variety. The three-month average looks a little better, but the pattern of net new job creation over the past three years still looks anemic and rather trendless, averaging 2.2-2.3 million annually. The unemployment rate continued its recent steady trend lower, falling to a five-year low of 6.7%. But that was mostly due to departures from the labor force, as the labor force participation rate – the employed plus those looking for a job as a percent of working age population – matched a 35-year low of 62.8% in January.

INVESTMENT OUTLOOK

January's weak opening for stocks may indeed be the start of a stock market correction, but it does not necessarily mean the end of the bull market that began in 2009. The biggest stock market retreat in 2013 was 6%, and it has been 27 months since the Dow Jones Industrial Average or the S&P 500 had a 10% or bigger correction. A market correction, at this juncture, should hardly come as a shock following gains of 150% in the Dow and 170% in the S&P 500 since March 2009.

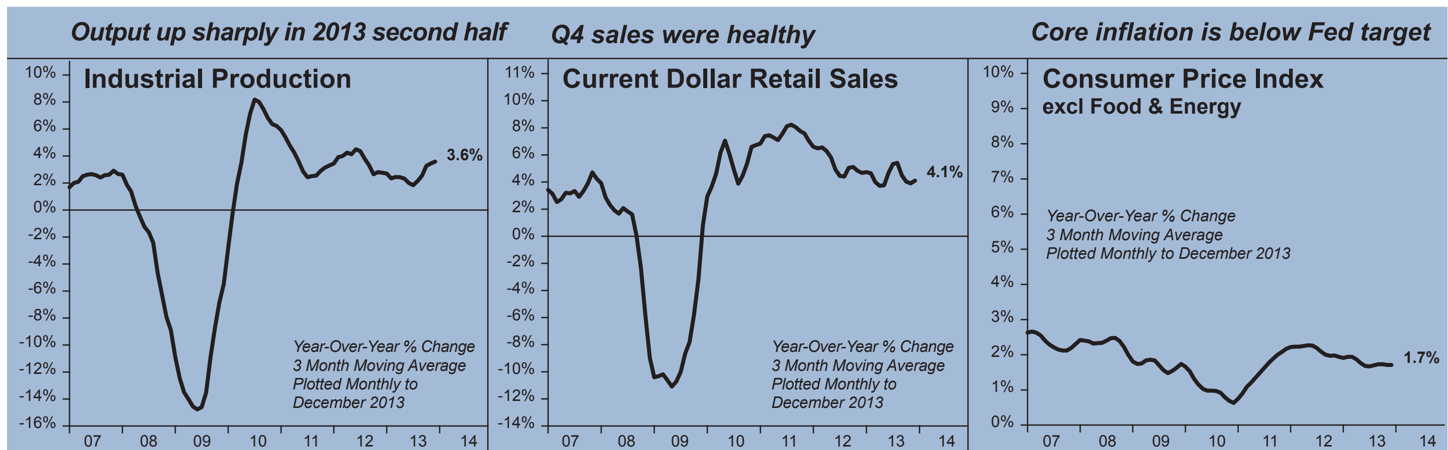
Total Investment Returns — 1/31/2014

	January	Last 12 Mos.
Dow Jones Industrial Average	-5.2%	16.1%
Nasdaq Composite	-1.7%	32.3%
S&P 500 Composite	-3.5%	21.5%
S&P MidCap 400	-2.1%	21.9%
S&P SmallCap 600	-3.9%	28.4%
MSCI World ($)	-3.7%	16.1%
MSCI World ex U.S. ($)	-4.0%	10.7%
Barclays Capital U.S. Aggregate Bond Composite	1.5%	0.1%
90-Day Treasury Bills	0.0%	0.1%
Consumer Price Index*	0.0%	1.5%

* Month and 12 months ended December 2013.

That is not to say that January's stock market sell-off should be dismissed out of hand. On January 29, the Fed announced that it will reduce its bond purchases by another $10 billion in February, bringing quantitative easing to $65 billion a month. The Fed's withdrawal of what amounts to a sliver of its total monetary accommodation ought not to raise serious questions about the positive economic momentum seen in the U.S. over the past few months. But it does appear to have played a role in January's emerging markets weakness. Barring something far worse than seen to date – either in terms of market weakness or global financial/economic disturbance – the Fed is unlikely to pull back from its tapering path, in Wright's opinion. Whether or not we have entered a bear market will be determined, not by the Fed's bond buying, but by the course of U.S. economic growth and corporate profitability over the balance of this year and next. Wright continues to believe that, in absolute terms and relative to the rest of the world, U.S. firms will acquit themselves well in 2014-15.

February 6, 2014



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